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Market Review and Outlook 2nd Quarter 2010

Review

In the second quarter, the fixed income market as represented by the Barclays Capital Aggregate Index posted a total return of 3.49%, as Treasury yields dropped sharply due to concerns about European sovereign debt, financial regulatory reform, slowing growth in China and fears of a double-dip recession. Flight-to-quality weighed on the non-Treasury sectors resulting in -51 bp of excess return for the overall fixed income market. The securitized sector registered its first quarterly negative excess return since December 2008, lagging Treasuries by -4 bp. The residential mortgage-backed sector's (MBS) performance was relatively flat at -1 bp versus duration-equivalent Treasuries. A rise in implied volatility was the key factor for this slight underperformance as mortgage spreads were actually tighter at the end of the quarter. The Ginnie Mae sector outpaced conventional MBS by +48 bp as the Federal Reserve's MBS purchase program, which targeted only conventional and primarily lower coupon MBS came to an end. Broad investor risk aversion negatively impacted even the high-quality commercial mortgage-backed (CMBS) sector which lagged Treasuries by -67 bp. The asset-backed (ABS) sector fared better, underperforming Treasuries by only -8 bp as investors showed a preference for the shorter duration profile of consumer ABS. The U.S. credit sector was the worst performer, trailing duration-neutral Treasuries by -223 bp for the quarter. Concerns over financial regulatory reform and the implications for future profitability weighed especially on the finance sector which lagged by -297 bp, while the utility and industrial sectors held up relatively better with underperformances of -208 and -180 bp respectively. There was also a tiering by credit quality; the single-A sector underperformed by -213 bp while the corresponding figures for the BBB and high yield sectors were -279 bp and -386 bp respectively. Investor flight-to-quality drove Treasury yields sharply down by 40 to 89 bp across the curve. The 2-year Treasury note ended the quarter at a record low yield of 0.6%, while the yield on the 30-year Treasury bond closed below 4% at 3.9%. With the Federal Reserve on hold for an extended period of time, investors reached for yield further out the curve causing the 2-year/30-year Treasury yield differential to narrow by 41 bp to 329 bp. Most government bond markets in developed countries underperformed the U.S. in the second quarter as investors sought the safe-haven status of U.S. Treasury securities. Despite the problems in Europe, central banks in Australia, New Zealand and Canada raised interest rates during the quarter citing broad-based recoveries in their domestic economies. Even though the hikes in foreign central bank rates made interest rate differentials less favorable for the U.S. dollar, the U.S. dollar index (measured against a basket of six major currencies) gained 6.1% as risk aversion caused all currencies, except the Japanese yen, to fall against the U.S. dollar with the euro declining the most (-9.4%).

Outlook

The fiscal and monetary programs put in place across many regions of the world after the collapse of Lehman Brothers in September 2008 have continued to provide strong support for global economic growth. However, the sustainability of this economic recovery is being adversely impacted by headwinds on several fronts including the contagion from the European sovereign debt crisis, the slowdown in China, large fiscal deficits in major developed countries and the weak housing market in the U.S. Redressing the fiscal imbalances in the European Union will require widespread restrictive fiscal policies across much of Europe which, in turn, may cause a double-dip European recession. China, a major driver of the global economic recovery after the Great Recession, is slowing down as policy makers tighten monetary conditions in response to an over-heating property market. In the U.S., recent economic data point to a soft patch. June employment declined by 125,000 with layoffs of temporary census workers the primary detractor to the headline number. Although private payrolls did expand by 83,000, this is weaker than would be expected at this stage of the economic recovery. The 0.2% drop in the unemployment rate to 9.5% was due to a decrease in the size of the labor force – not a positive development. Following the expiration of the home-buyer tax credit, recent housing data have been disappointing and consumer confidence has declined. There are, however, some positive signs. In the U.S. and abroad, manufacturing and service sector surveys indicate that these sectors are continuing to expand although at a more moderate pace. Some auto manufacturers are adding staff to increase summer production, and the Business Roundtable CEO survey of employment plans hit its highest reading since 2006. Also, senior management teams at several major companies are expressing cautiously optimistic outlooks about improving consumer demand.

The slow pace of recovery in the jobs market coupled with still relatively tight credit conditions, 6+ million homes in the foreclosure pipeline, a banking system that is not fully healthy and a benign inflation backdrop are likely to refrain the Federal Reserve from raising interest rates until, at least, 2011.

Our outlook for the securitized sector is unchanged. Despite strains in the underlying collateral performance in the ABS and CMBS sectors, and the prospect for further marginal deterioration, valuations in the higher quality tiers remain compelling. Moreover, year-to-date ABS issuance is running about 16% behind last year's pace, largely because of a lack of credit card supply, another positive for the sector. Therefore we maintain our overweight in these sectors. Corporate fundamentals continue to improve with declining leverage, higher cash balances on balance sheets and lower default rates. Cheaper valuations (risk premiums) now compared to the start of the year coupled with a favorable technical backdrop (lighter issuance) lead us to maintain an overweight to the credit sector. In particular, we continue to favor the financial sector as regulatory reform will be less onerous than expected. In the non-dollar markets, we believe the U.S. dollar will continue to be well-supported by stronger economic growth in the U.S. relative to Europe and Japan. However, the string of austerity measures being enacted in Europe will temper the euro's decline. Lastly, we remain underweight Treasuries and Agencies.

Barclay Capital Indices	Q2 Return(%)	Excess Return (bp)	YTD(%)	Excess Return (bp)
Aggregate Index	3.49%	-51bp	5.33%	+30bp
Intermediate Agg Index	2.92	-27	4.78	+56
Government/Credit Index	3.88	-80	5.49	-33
Int. Gov/Credit	2.97	-43	4.56	+2
Treasury Index	4.68	-	5.86	-
Agency Index	2.54	0	3.76	+34
US Credit Index	3.27	-223	5.62	-109
Asset-backed Index	2.54	-8	4.81	+128
Mortgage-backed Index	2.87	-1	4.46	+75
CMBS Index	2.78	-67	12.14	+750